# Huggan White Wealth Management

***Protect Capital. Manage Risk. Provide Income.***

## Investment & Strategy Commentary

**July 2018**

*“Kids Say the Darndest Things!”*

Many will recall the mentioned title from Art Linkletter’s television series, “*Art Linkletter’s House Party*” which aired five days a week from 1945 to 1969. The premise of this show was to ask children between the ages of 3 and 8 random questions, with the expectation that the unscripted responses would be cute, witty and simplistically accurate from the viewpoint of a youngster. Often times the responses were met with hysterics and Art would utter, “Kids Say the Darndest Things”. Yours truly was recently reminded of the irony of this statement when my son and I were in a passionate and hotly contested children’s card game called Pokémon. Although the concept of the game is still foreign to my aging comprehension, the basics are to collect the most amount of cards across a Pokemon species. Each card contains a number of variables including power, health, ability, speed etc., with a rating summarizing the total of these characteristics; the higher the rating, the better the card. As the game progressed my son emphatically expressed how superior his cards were to mine and that my chances of success were limited. As the match progressed, I asked him how he accumulated such powerful cards, to which he responded, *“I traded for them with Spencer* (his cousin) *to get better cards”!*

Sensing an opportunity to capitalize, I asked him if he was willing to trade one of those “good cards” for a combination of my cards. With an inquisitive and surprised look he simply stated, *“No! These are some of my best cards, why would I trade them to you.”* Admitting defeat I replied, *“Good point son, why would you trade them, they’re your best!”* Indeed, kids say the darndest things.

Fittingly, this same concept is something that we have applied to our portfolio management process throughout the first half of 2018. If you recall, heading into this year we expressed caution with an expectation that a more meaningful correction was due as the historically low levels of volatility seen in 2017 continued into January, helping push sentiment and valuations to extended levels and equity markets to new all-time highs. The corrective action that eventually began in late January created an environment in which volatility significantly increased throughout the first quarter. However, when faced with this heightened instability, our process allowed us to remain focused on the merits of portfolio construction: risk management, diversification and proper asset allocation. This led us to also avoid rash decision making, while holding onto what we perceived as our best “cards”.

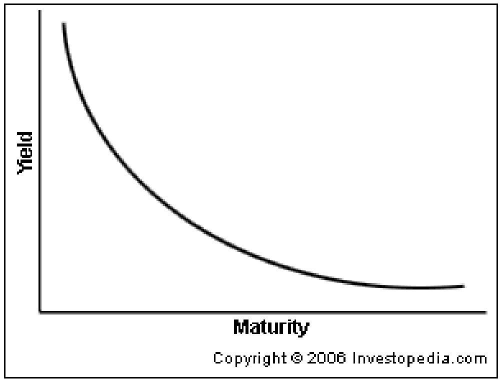
Throughout the second quarter, volatility abated as a number of the aforementioned inputs slowly worked off their overbought condition. Certainly markets were not completely insulated from periodic bouts of volatility as headline news and geopolitical rhetoric oscillated between two extremes almost on a daily basis. Still, the ability for equities to absorb these “uncertainties” illustrates the resilience and underlying strength of this market. As we now enter the third quarter and second half of 2018, we believe the same positive attributes that contributed to the gains throughout the 2nd quarter will continue, allowing for a successful recapturing of the January high and a subsequent push to new all-time highs. Despite the headline risk of trade wars, tighter monetary policy, slower global growth and talk of peak earnings, we believe the underlying fundamentals that have supported our core thesis remain in place. As such, our strategy will reflect this view and mandates across clients’ portfolios will be positioned accordingly. The core tenets of our thesis remain:

- Economic growth remains buoyant and the availability of credit remains attractive
- Central Bank policy will be measured, as core inflation and unemployment resides within targets
- The slope of the yield curve is still positive, reducing any imminent threats of recession in the near term
- Earnings drive stock prices – 2nd quarter earnings should be supportive of higher valuations and may actually surprise to the upside
- Asset allocation remains hesitant towards equities as evidenced in fund flows (read: contrarian)
- Technical indicators are improving and in some cases pressing new highs
- Active Portfolio Management is essential to generate targeted risk-adjusted absolute returns

Looking at the first point, global economic growth has slowed after reaching peak growth, yet the trend remains positive. Real GDP growth in the U.S. for 2017 came in at 2.3% and consensus is calling for a 3-4% growth rate collectively for 2018. The impact of fiscal stimulus (tax cuts) and deregulation is likely still in the early stages of spilling over into economic data. Considering growth was anemic and below expectations after the 2008 financial crisis, further acceleration of growth should result in a stronger profit picture and enhanced corporate activity. This bullish outlook is being reflected across a number of key indicators such as the Small Business Optimism index which resides near cyclical highs, manufacturing and service PMIs that remain in expansionary territory and confidence readings, both current and forward expectations that are surging. Capital expenditures (CAPEX) across corporate planning have also ramped up as the era of cheap money has dissipated and financial engineering has become less attractive. In response, as opposed to buying back their own stock, CEOs will likely return to investing capital into growth initiatives to build shareholder value. The corollary of such welcomed initiatives is new hiring, wage growth, increased productivity and a further boost in consumer confidence. Here in Canada, growth remains relatively muted with latest quarterly data reflecting a deceleration in household spending, lower exports of non-energy products and a decline in housing investment (-1.9 percent). Expressed at an annualized rate, real GDP was up 1.3 percent in the first quarter, but below market expectations of 1.8 percent growth. More recent data suggests though that Canada's economy continues to operate close to its capacity and the composition of growth is shifting. While temporary factors are causing volatility in quarterly growth rates, the Bank of Canada projects a pick-up to 2.8 percent in the second quarter and a moderation to 1.5 percent in the third quarter. Second quarter data will be key, as a softer Canadian dollar and higher energy prices should allow for a slight tick up in nominal GDP.

Central bank policy remains essentially in line with expectations. As noted several times in the past, our view is that the path of least resistance is higher for both the Bank of Canada and the U.S. Federal Reserve. The gradual and measured pace at which rates are moving higher is in response to the upbeat economic activity as noted above and a return to "normal" policy as opposed to "aggressive" that some may suggest. Moving forward, we expect this trend to continue as data shows Federal Reserve members remain determined in their approach to lift rates from the generational lows witnessed between 2009 and 2015. The Bank of Canada's recent release confirmed this view in the statement, *"Governing Council expects that higher interest rates will be warranted to keep inflation near target and will continue to take a gradual approach, guided by incoming data. In particular, the Bank is monitoring the economy's adjustment to higher interest rates and the evolution of capacity and wage pressures, as well as the response of companies and consumers to trade actions."*

Much talk continues regarding tighter monetary policy and the slope of the yield curve. Essentially, if short term debt instruments are higher than longer term debt instruments the slope of the curve is said to be inverted. As can be seen in the following chart, the "X" axis shows maturity, or term of the debt instrument, while the "Y" axis shows the yield of the same instrument. The most widely followed yield relationship is between the U.S. 2 year treasury and the U.S. 10 year treasury and is seen as a decent measuring stick of the business/economic environment; early, mid or late cycle. The slope of the yield curve and availability of credit is driven by monetary policy (see interest rates and Bank policy above). Over the past seven economic cycles, a recession doesn't begin for a median of 19 months after the initial date of inversion (the 2 year treasury yield is higher than the 10 year treasury yield). As the current economic cycle has matured, the yield curve has progressively "flattened". Yet, as of the end of the second quarter, the slope of the curve remains positive and any recessionary fears should remain distant. The biggest risk to this outlook would be an overly aggressive Central Bank in an attempt to normalize rates. Such an error, although not fatal, would likely reignite volatility as investors reassess their desire to hold riskier assets. At this time though, it does not present any material risk that would result in an immediate shift in our asset allocation.




The mother's milk of equity market performance is earnings. The relationship of stock market performance as per the S&P 500 and the direction of earnings are a tightly correlated 0.94. After the earning recession of 2014 to 2016, the earnings story has dramatically improved as fiscal stimulus, regulatory reform and economic progression, both domestic and global, have contributed to robust earnings growth. Heading into second quarter earnings reporting season, cumulative earnings estimates call for growth of approximately 20%. All 11 sectors are expected to contribute to earnings growth, with more cyclical areas of the market such as energy, materials, industrials and financials providing a significant contribution. 2018 earnings per share growth also show expected gains of 22% or ~$162 for the calendar year (chart last page), underscoring a current valuation of ~17x, a level that we consider healthy and reasonable given forward expectations. Considering valuations were trading near 20x as we entered 2018, any earnings surprise to the upside and the current backdrop may prove to be too conservative. Quick math allows for an S&P 500 well north of 3,000 at 20x valuation based on $162 consensus. That represents a gain of more than 10%+ from current levels. As we work through the next few weeks, more details of earnings and forward guidance will be paramount to this outlook.

From an asset allocation perspective, we continue to be concerned at the unrelenting flow of capital into fixed income and what are perceived as "no risk" securities. As the brilliant folks at Strategas Research recently noted, *"The case may be largely circumstantial but it appears as if persistently low yields have prompted many investors to use bond funds as a proxy for money market mutual funds. With the exception of the taper tantrum in 2013, this has worked out. In that year, bond fund redemptions picked up markedly in the first week of the month. As for stocks, inflow into passive strategies like ETFs have been more than offset by outflows from mutual funds."* Quick analysis of the following table (*Strategas*) illustrates the aversion of equities relative to bonds, with $1.1 trillion USD coming out of mutual funds (actively

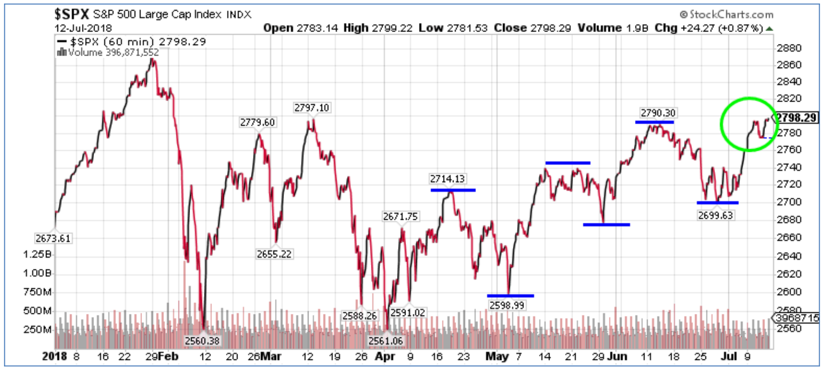
Net Flows into Mutual Funds + ETFs ($BN)

| Year | Domestic Equity | | International Equity | | Bond | Money Mkt |
|---|---|---|---|---|---|---|
| | MF | ETF | MF | ETF | | |
| 2009 | (27.6) | 30.9 | 29.6 | 39.6 | 417.2 | (539.1) |
| 2010 | (81.1) | 46.7 | 56.7 | 41.5 | 262.0 | (525.1) |
| 2011 | (133.3) | 47.3 | 4.1 | 24.3 | 163.7 | (124.1) |
| 2012 | (159.1) | 80.9 | 6.4 | 51.9 | 358.5 | (0.2) |
| 2013 | 18.1 | 104.1 | 141.4 | 62.8 | (59.0) | 15.0 |
| 2014 | (60.2) | 141.5 | 85.4 | 46.6 | 94.5 | 6.2 |
| 2015 | (170.8) | 65.4 | 93.9 | 109.7 | 29.4 | 21.5 |
| 2016 | (235.4) | 167.6 | (24.5) | 20.1 | 190.1 | (30.3) |
| 2017 | (236.0) | 186.0 | 76.7 | 159.8 | 381.1 | 106.9 |
| 2018 YTD | (84.6) | 34.3 | 51.4 | 40.6 | 110.0 | (6.9) |
| *TOTAL* | (1169.9) | 904.7 | 521.1 | 596.8 | 1947.5 | (1076.1) |

managed) and approximately $2 trillion USD moving into bonds. With interest rates ratcheting higher, we fear the prejudice to overweight "safe haven" fixed income is a risk in itself. The path forward will require thoughtful active management as these asset classes will provide either a headwind or tailwind to an investor's total return.

Lastly, looking at the technical picture, while May/June were all about trade rhetoric and the fear it generated, July/August will likely be lifted by a continued follow through of strong Q1 earnings and the fundamentals of a buoyant economy and an even healthier corporate backdrop as noted above. With sentiment still broadly negative and hesitation to commit capital broadly reflecting this emotional "headline risk", each test and break of resistance should be met with a fresh infusion of cash. When indices put in a series of higher highs and higher lows as seen in the chart on the next page, it suggests that the consolidation process that began in early

January has run its course. With the March snapback high of 2,801 now within a few points, a break above this level would be a thorn in the side for those in the bearish camp. We think the odds are tilted to the upside.




In summary, our work continues to point to a relatively optimistic environment for investors. Certainly, we are aware of and are closely monitoring the majority of the moving parts that remain at the forefront today. Our process continues to evolve on a daily basis as we continue to challenge ourselves to improve upon our offering. Our clients' objectives rest firmly at the top of our priorities as we work diligently to ensure that each pre-established target is achieved. Our holistic, goals based approach that focuses on the "bigger picture" inputs of a wealth management plan, hopefully allow our clients to remain focused on and committed to what is most important to them. It shouldn't be the intraday price fluctuations, or the speculation of geopolitics, or the constant grandiloquence of the 24 hours news channels. Much like children say the darndest things, the media often has a habit of saying the darndest and most irrelevant things. In the end, the ultimate barometer of success is meeting and exceeding your goals over a time frame expressed in years, not days, weeks, months or even quarters.

Thank you for your continued trust and confidence in allowing us to manage your financial affairs.

We will keep you updated as warranted.

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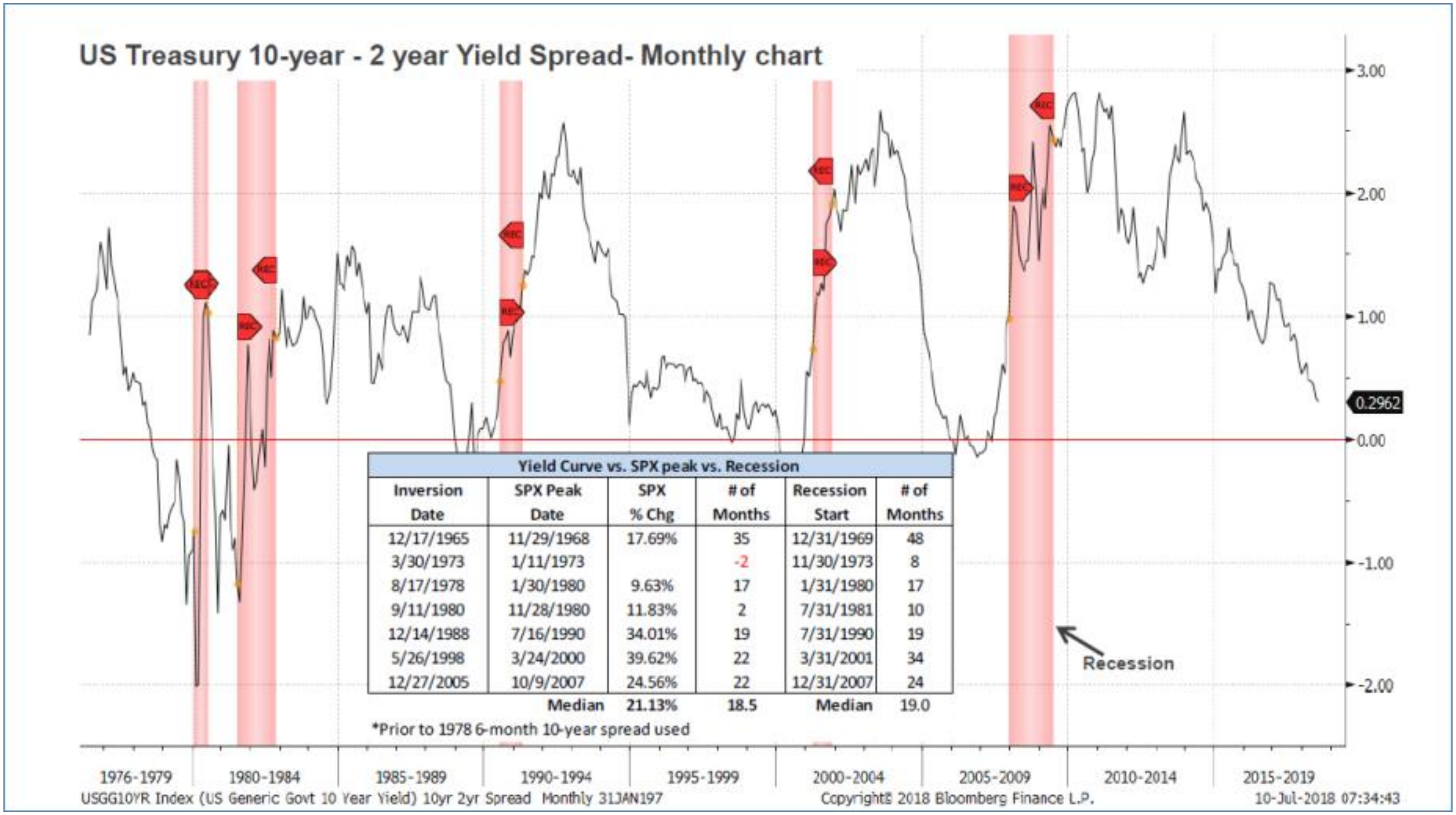
**QUARTERLY REPORTED RESULTS AND FUTURE EXPECTATIONS**

Industry Analyst Estimates - S&P 500 Bottom Up ($/share)

| Year | 1Q | 2Q | 3Q | 4Q | CY |
|---|---|---|---|---|---|
| 2004 | 15.87 | 16.74 | 16.59 | 17.83 | 67.10 |
| 2005 | 17.95 | 19.11 | 18.86 | 20.19 | 76.28 |
| 2006 | 20.73 | 22.31 | 22.60 | 22.44 | 88.18 |
| 2007 | 22.71 | 24.40 | 21.31 | 16.14 | 85.12 |
| 2008 | 18.96 | 19.78 | 17.49 | 5.62 | 65.47 |
| 2009 | 12.83 | 16.03 | 16.36 | 16.80 | 60.80 |
| 2010 | 19.71 | 21.48 | 21.75 | 22.55 | 85.28 |
| 2011 | 23.50 | 24.14 | 25.65 | 24.55 | 97.82 |
| 2012 | 25.60 | 25.84 | 26.00 | 26.32 | 103.80 |
| 2013 | 26.74 | 27.40 | 27.63 | 28.52 | 109.68 |
| 2014 | 28.18 | 30.07 | 30.04 | 30.54 | 118.78 |
| 2015 | 28.60 | 30.09 | 29.99 | 29.52 | 117.46 |
| 2016 | 26.96 | 29.61 | 31.21 | 31.30 | 118.10 |
| 2017 | 30.90 | 32.58 | 33.45 | 36.02 | 132.00 |
| 2018 | 38.08 | 39.19 | 41.02 | 42.73 | 161.22 |
| 2019 | 41.19 | 43.31 | 45.30 | 47.35 | 177.09 |
| 2020 | | | | | 193.45 |

Source: Thomson Reuters I/B/E/S




**Yield Curve vs. SPX peak vs. Recession**

| Inversion Date | SPX Peak Date | SPX % Chg | # of Months | Recession Start | # of Months |
|---|---|---|---|---|---|
| 12/17/1965 | 11/29/1968 | 17.69% | 35 | 12/31/1969 | 48 |
| 3/30/1973 | 1/11/1973 | | -2 | 11/30/1973 | 8 |
| 8/17/1978 | 1/30/1980 | 9.63% | 17 | 1/31/1980 | 17 |
| 9/11/1980 | 11/28/1980 | 11.83% | 2 | 7/31/1981 | 10 |
| 12/14/1988 | 7/16/1990 | 34.01% | 19 | 7/31/1990 | 19 |
| 5/26/1998 | 3/24/2000 | 39.62% | 22 | 3/31/2001 | 34 |
| 12/27/2005 | 10/9/2007 | 24.56% | 22 | 12/31/2007 | 24 |
| | Median | 21.13% | 18.5 | Median | 19.0 |

*Prior to 1978 6-month 10-year spread used